Audit's
MONTHLY NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS
Realty Trust Review

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WILL MORE INDEPENDENT MANAGEMENT COMPANIES SELL?

Details of the sale of Group Counselors, Inc., adviser to *Mortgage Investment Group* of Los Angeles, to Chicago-based Conill Corp. are surfacing to raise anew the question of whether other management companies will be sold to commercial banks and other potential trust sponsors. Some clues are found in the GCI-Conill transaction. The complex sales agreement indicates the GCI-Conill transaction must have been in negotiation for some time before its announcement last August. The proposal has gone the rounds before regulatory authorities and only now, six months later, is emerging, partly in Conill's proxy mailed last week and partly in a MIG proxy being mailed today. The lesson: if anyone thinks buying a management company is quick, think again.

And the price of a management company remains as unclear as before. The GCI transaction has a potential value of $14 million for the 400,000 shares of Series A preferred GCI could receive. But only 28,000 shares will be exchanged initially; the rest depends upon future earnings of GCI, Conill and the trust evaluated under a complex formula. The GCI manager, led by James A. Harper, is setting a number of welcome precedents by asking shareholders to approve Mar. 30 several changes, including: 1) change MIG's name to *Continental Illinois Realty*, 2) an unchanged management contract with a renamed Continental Illinois Realty Advisers, Inc. Other independent trusts have been mentioned as candidates for bank takeovers. But with the brighter money market climate, most independent managers tell us they now intend remaining independent. The MIG sale may remain rare for some time.

KENNETH D. CAMPBELL, EDITOR AND PUBLISHER / **AUDIT** INVESTMENT RESEARCH INC., 230 PARK AVENUE, SUITE 555, NEW YORK, N.Y. 10017 (212) 725-1410

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THE MOVE TOWARD LAND TRUSTS: STILL A MODEST PUSH, NOT A RUSH

Cabot, Cabot & Forbes Land Trust has filed a proposed $50 million offering and thus propelled the real estate trust industry in still another direction, subordinated land lending. Subordinated land loans have been a standard real estate device in income properties for years, but the CC&F Trust would be the first public vehicle to specialize in this arcane field.

Specifically, the CC&F Trust would intend investing up to 75% of assets in land beneath commercial, industrial and multi-family apartment projects. The land is leased to building owners under net ground leases which typically will provide additional rentals based upon increases in gross operating rents of the property.

Like any specialized field, this one has special risks too. Land loans are subordinated to other indebtedness of the building (and land in some instances). If the lessee (the building owner-manager) defaults, foreclosure is ordinarily not feasible and the subordinated land lender would likely have to take over the property. And since land leases normally are made for long terms, appreciation of land values may make rentals out of line with current conditions. The sharing of the building's gross rentals is a way of compensating for such inflation.

In addition, CC&F Land Trust could also lend up to 20% of assets on land purchase and development loans.

The trust manager, CC&F, is one of the nation's largest real estate development and investment companies. During the past five years it has developed 21 industrial parks with 1,245 acres and constructed 51 buildings with 2.3 million square feet in these parks. CC&F retains 2,800 acres in these parks for future development. The company's developments include King of Prussia Park near Philadelphia, the CC&F Office/Industrial Park in San Francisco and the CC&F-Los Angeles Industrial Center.

Other trusts have already done a limited amount of subordinated land lending. *Realty Income Trust*, the ASE-listed trust sponsored by Textron interests, has been active in this field in the past, although current investments are not large. *North American Mortgage Investors*, now NYSE, has also done some work in this area.

But the biggest subordinated land lenders have been the private real estate trusts, until very recently a little-known part of the realty trust industry. Two are especially active in this field: *Property Capital Trust* of Boston and a group of trusts managed by *Investors Central Management Corp.* of New York City, a company formed by mortgage bankers in the middle 1950s to place and service mortgages for pension funds and other institutional investors.

Property Capital, according to managing trustee and president John A. Cervieri, Jr., earned $928,000 in its first full year, ended July 31, 1970. The trust had $27.78 million invested at year-end and commitments of $14.48 million outstanding.

Property Capital invests funds for a limited number of investors, mainly pension funds and other fiduciaries, which together represent about 130 investors, above the 100 owners required to qualify for REIT tax treatment. The roster of trustees is indicative of the institutional sponsorship. Irwin Baron of James Felt & Co. is chairman, and other trustees include Carroll J. Force, manager of private placements for the General Electric Pension Trust; Lathrop S. Haskins, retired senior vice president of Morgan Guaranty Trust Co.; Richard S. Ellwood, partner of White, Weld & Co., John C. Slagle, retired senior vice president of First National City Bank, and Walter F. Leinhardt, partner in the law firm of Paul, Weiss, Goldberg, Rifkind, Wharton & Garrison.

Comparatively little is known publicly about the ICMC trusts, which are managed by Arthur Viner. The trusts specialize in subordinated land loans and make their investments for a group of bank-trusteed pension funds who do not have real estate expertise. But the group refrains from additional public comment upon advice of counsel.

The third major private trust, *Institutional Investors Trust*, is advised by a subsidiary of DLJ Real Estate, Inc., affiliated with the institutional brokerage firm of Donaldson, Lufkin & Jeanrette. The trust was believed to have had initial capital of about $40 million subscribed by a group of institutional investors. The trust began operating July 1, 1970, and is believed to have the largest share of funds invested in short-term construction loans.

There has been and continues to be recurring speculation among securities underwriters that some of the private trusts will ultimately shed their privacy for public ownership. Since two of the three trusts have experience in land lending, this could well mean that other major land trusts are waiting in the wings until they see how the CC&F Trust is received.

Other major proposed trust offerings include a $100 million trust, *Northwestern Mutual Life Mortgage & Realty Trust*, sponsored by the Milwaukee-based insurance company. It would specialize in long-term mortgage and equity investments. The offering would be half convertible debentures and half equity.

Two operating trusts found the market to their liking and are proposing offerings. *Lincoln Mortgage Investors* of Los Angeles is proposing to offer $12 million of convertible debentures with warrants attached to purchase 600,000 shares.

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PENDING REALTY TRUST OFFERINGS - 2/23/71

Yes

Trust	Filed	Shares (000)	Wts. (000)	Cv.Deb. (Mil.$)	Max.+ Price	Proceeds (Mil.$)	Underwriter
New trusts							
American Cap. Mtg.	11/24/70	200	50	---	$500a	$5.0	Kelly & Morey
American Sec. REIT	1/29/70	1,000	1,000	---	15b	15.0	Halle & Steiglitz
Cabot, Cabot & Forbes LT	2/9/71	1,250	---	$25.0	200c	50.0	Paine, Webber, Jackson, Curtis
Dominion Mtg &Rlty.	2/8/71	500	500	---	12b	6.0	Lief Werle & Co.
Gulf Mtg. & Realty	3/24/70	1,750	1,750	---	20b	35.0	Goldman, Sachs; Reynolds; Shearson, Hammill
Holiday Inns Inv.	7/22/70	3,750	---	75.0	200c	150.0	Merrill Lynch;Smith Barney;Equitable Sec
Northwestern Mut Life	2/22/71	2,500	---	50.0	200b	100.0	Morgan Stanley
Riverside REIT	11/18/70	125	125	---	20b	2.5	J.D. Winer
Sec. First Inv. Tr.	4/8/70	500	---	---	10	5.0	First Sec. Inv.
						$368.5	
Existing trusts							
Lincoln Mtg. Inv.	2/16/71	---	600	$12.0	$100d	$12.0	W. E. Hutton
National Mtg. Fund	2/4/71	400	---	8.0	162½c	13.0	W. E. Hutton
						$25.0	

+Based on filings with S.E.C. a-Units of 20 sh. & 5 wts. b-Units of one sh. and one wt. c-Units of 5 sh. & $100 deben. d-Units of $100 deb. & 5 wts.

Lincoln has 1,114,000 shares outstanding. *National Mortgage Fund* of Cleveland is proposing a combination offering of 400,000 shares and $8 million of convertible debentures. NMF has 687,280 shares outstanding.

Only a single mortgage trust offering was completed in the past month, the $50 million *State Mutual Investors* offering of Feb. 4. This made February the most anemic month for trust offerings since July and August, 1969, when one offering was made each month for $25.0 and $26.5 million respectively. More than anything else, the dearth of February offerings reflects the fact that new filings shriveled to near zero last fall and thus the pipeline was nearly empty during the January-February surge in prices.

State Mutual, the new trust, offered 1,250,000 shares and $25 million of 6 3/4% debentures, convertible at $21, through Bear, Stearns & Co. and Bache & Co. The trust intends to stress long-term mortgage loans and development loans, although about $27 million of initial proceeds will be invested in short-term construction loans which the trust will later fund with long-term mortgages. The initial short-term loans have an estimated composite yield of 12.12%, while long-term loans on these properties will yield 10.24% fixed yield plus 2% of gross income. Development loans have an estimated 12.2% yield. The Trust is sponsored by State Mutual Life Assurance Company of America, 440 Lincoln St., Worcester, Mass. 01605. H. Ladd Plumley, State Mutual chairman, is trust chairman and James T. Wilcox, vice president for mortgages and real estate, is president of both the trust and the adviser, The America Group Management Corp.

As a result of this activity, the shelf of pending registrations stands at $393.5 million as of Feb. 23. Trusts in registration are listed on page 3.

THOSE LONG-TERM MORTGAGE TRUSTS: SITTING HIGH AND FAT

A year ago a good many people expected the 12% and 14% short-term construction loans to continue forever. But interest rates have been falling since then, with the prime rate plummeting in the last three months to a 5 3/4% level that is 2.75% below the peak of 8.5%. Construction loans have fallen right along with everything else, with most new commitments in the 10%-11½% range. Portfolio yield for the short-term trusts generally keeps on rising or falls very slowly in such situations, so the impact of the rate drops hasn't surfaced yet for many trusts.

But the past month the downward pressure became apparent as *Associated Mortgage Investors, Fidelity Mortgage Investors,* and *Mortgage Investors of Washington* all reported slightly lower earnings for the latest quarter. Some of the decline was the result of a decision to go slower at Associated, for instance, but overall the declines reflect the pressures on short-term trusts. One further result: dividend yields for short-term trusts remain relatively high as investors doubt the ability of trusts to roll over their portfolio with loans of equal yield and quality.

Everyone's hurting, it seems, except the long-term mortgage trusts. The long-term trusts emerged last spring with the underwriting for Connecticut General Mortgage and Realty Investments and have been followed by similar trusts sponsored by such nationally known institutions as Equitable Life, Massachusetts Mutual Life, Mutual Life Insurance of New York, and Bank of America, all offerings in the second half of 1970.

This quintet accounts for about 65% of the $855.8 million assets now concentrated in the 15 long-term mortgage and equity trusts (see table). All have convertible securities outstanding. As the table below shows, capital funds--i.e., $520.0 million equity and $292.4 million convertible debt--account for 95%

of assets at present.

All signs point to great diversity in this group. Last month we described the operations of Medical Mortgage Investors. Hotel Investors, a trust specializing in hotel and motel property, is another specialist. The major trusts already show signs of pursuing very broad investment goals. But since many long-term trusts have yet to report their first quarter, this picture of diversity has been slow in coming into focus.

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BALANCE SHEET SUMMARY FOR LONG-TERM TRUSTS - Mil.$

Trust (date)	Equity	Conv. deben.	Total capital	Total assets
BT Mtg. Inv. (Dec.'70)	$15.1	$9.5	$24.6	$29.9
BankAmer. Rlty.(Oct.'70)	49.1	23.4	72.5	87.2
CleveTrust (E)	46.0	--	46.0	46.0
Conn. Gen. Mtg.(Dec.'70)	73.5	45.7	117.2	134.9
Cousins Mtg. (Nov.'70)	39.1	--	39.1	42.1
Equitable Life Mtg. (E)	67.2	75.0	142.2	142.2
Fidelco Growth (E)	18.2	--	18.2	18.2
First Memphis (E)	20.9	--	20.9	20.9
Hotel Inv. (Nov.'70	13.4	15.0	28.4	29.1
MassMutual (E)	45.0	50.0	95.0	95.0
Medical Mtg. (Sept.'70)	30.9	--	30.9	31.8
MONY Mtg. Inv. (Nov.'70)	46.4	49.8	96.2	98.4
Old Stone Mtg. (E)	5.5	--	5.5	5.5
PNB Mtg. (E)	27.5	--	27.5	27.5
State Mutual Inv. (E)	22.1	25.0	47.1	47.1
TOTALS	$520.0	$293.4	$813.4	$855.8

E-Estimated from prospectuses; trust has not reported.
See supplement for latest earnings and dividends.

But when the long-term trusts began, permanent mortgages were viewed by some as dull as dishwater. And in a period of ever rising interest rates and inflation, the long-term mortgage just didn't have a ghost of a chance of producingcompetitive yields. Or so it seemed.

The almost universal bias against long-term mortgages by the short-term mortgage trusts was founded upon a reading of recent economic history. Both the older national short-term trusts, Continental Mortgage and First Mortgage, had originally invested in FHA-VA loans and reduced their holdings because rising interest rates had lowered the value of their fixed income. Long-term mortgages, like long-term bonds, were in their private bear market and were no place to invest.

But in retrospect the long-term mortgage trusts were right on target. By jumping into the market when they did, many of them locked in yields that are among the highest for long-term mortgages in the last five decades. Immediately above we have cited the portfolio yields for State Mutual Investors, the newest long-term trust. SMI will initially put its money to work with 12.1% short-term construction loans and roll these loans over into 10.25% permanent loans when construction is done in 1972. The $24.5 million of permanent loans thus generated will also return 2% of gross income on the properties, mainly apartments.

What this points up is the fact that the prejudice against permanent loans was based upon fixed-rate FHA-VA loans. They don't change. But nothing has changed more in the past three years than the conventional mortgage, especially for income properties. Some form of inflation hedge has become almost standard, with the 2% of gross being the commonest method. Another less common method is the sharing of gross once revenues reach certain levels. Builders and developers have of course resisted such revenue sharing, because it reduces the leverage they can get on any given project. But the practice is fairly well established.

More importantly, our checks with major insurance company lenders indicate that

percentage-of-gross loans have not softened appreciably, even with the plunge in short-term rates. The rates on income property loans have not softened appreciably, with 8½%-9½% still common in negotiations.

So the long-term trusts stand in the enviable position of having high-rate loans on their books, ones with either outright bans on prepayment or heavy prepayment penalties. They do not have the problem of rolling their investments every year or 18 months. And interest on their prospective investments has not declined nearly as quickly as in the short-term market. In short, they have been left high and very fat. And if you believe as we do that interest rates will begin firming and rising moderately later this year, then the long-term trusts are indeed ideally situated.

But it's one thing for a trust to be in a strategic position and quite another for the trust shares to represent a good investment value. And there's real confusion on the ways a long-term trust can be expected to grow. Because there is no real possibility to work a big spread between their own borrowing rates and their portfolio yields, traditional leverage is denied the long-term trusts. In theory the trusts must have long-term capital to support their long-term loans. And they need big dollar amounts, since their funds will stay invested for a long time rather than being rolled over.

Thus nearly all long-term trusts have come to life with massive capitalizations split half-and-half between equity and convertible debt. The initial offerings have been structured so that the subordinated debt is convertible at prices 5%-10% above the adjusted offering price for shares. The State Mutual debentures, for instance, are convertible at $21 while the shares were sold at an adjusted price of $20, or a 5% premium.

In theory the revenue-sharing mortgages of the long-term trusts should provide an income stream with moderate growth. The long-term trusts can, theoretically, borrow in the short-term market to fund construction loans tied to their long-term commitments, thereby reaping the same spread that short-term trusts do.

And obviously they can return to the securities market with secondary offerings of either shares or convertible debt. The key is the cost of new capital. This is no different than for short-term trusts. If trust shares are trading in the market at a price that permits it to raise relatively cheap capital, then new offerings will be advantageous to existing shareholders. We've said it before but it bears repeating: the cost of capital for a trust is the reciprocal of its price/earnings multiple. For instance, the oldest long-term trust, Connecticut General, trades at about 15 times latest annualized earnings, implying a 6.7% cost of capital. With the trust able to invest new funds at 10% or so, sale of new shares would appear to be advantageous to present shareholders.

Nothing appears to have excited investors more than the emergence of the long-term trusts with major institutional sponsorship. Already Conn Gen, Equitable Life, MassMutual and MONY Mortgage trusts have listed on the NYSE. Some major securities firms have concentrated their analytical work on them because they do not have to sell the quality of their blue-chip sponsors to institutional investors. On the surface the long-term trusts appear to have conflicts of interest with their sponsors. Most are managed by the same personnel as the institution's own mortgage portfolio, which may be indistinguishable from the trust's holdings. In these cases however the appearance of conflict may overstate the actuality. We will be saying more about long-term trusts in the future. Below we review two whose records are now emerging.

Connecticut General Mortgage and Realty Investments is developing a portfolio that closely parallels holdings of the parent insurance company of the same name. Since its initial public offering in March 17, 1970, CGM has invested $114.2 million in real estate and at the end of its December quarter had another $141.9 million in commitments outstanding.

CGM invests primarily in major income property centers, and about 47% of commitments have been for shopping centers. Apartments account for about 15% and distribution facilities 10%. The insurance company has long been known as a leading shopping center financier, and the trust has continued this speciality by seeking out enclosed mall, regional centers. The trust's funded investments at Dec. 31 had an average fixed minimum return of 10.1%, excluding equity or revenue participations. The bulk--83% of current holdings--are in either short-term construction loans or "standing" loans bridging the time between completion of a building and funding of its final mortgage. During the current quarter the trust has drawn down about $10-$15 million in bank lines to permit fuding of additional short-term loans.

The trust will begin taking on its long-term character in April when funding of long-term commitments is scheduled to begin. Funding should take a year. The trust already has generated $83.8 million in long-term commitments at a minimum fixed return of 10.4%. All these loans have some equity or participation arrangement and all are guaranteed against refunding for 10 years. Commitments yet to come on the books are especially valuable in light of current market conditions: less than half of current CG insurance company loans have equity kickers and the going rate is about 9½%.

In December CGM also completed its first major equity purchase by buying the Montclair Plaza Shopping Center on the San Bernardino Freeway about midway between downtown Los Angeles and San Bernardino. CGM paid approximately $17 million for the center, including assumption of a $12.6 million fixed-rate loan at 6 3/8%.

The shares are currently priced at about 15 times annualized earnings for the December quarter and at 13.6 times our estimate for fiscal 1972.

CONNECTICUT GENERAL MORTGAGE (CGM-NYSE)
Year ends March

Quar.	---Earnings/share--- Primary	Diluted	Div.
June	$0.33	0.33	$0.30
Sept.	0.43	0.41	0.36
Dec.	0.45	0.43	0.38
Mar.'71	E0.48	E0.46	E0.46
EFiscal '71	E1.69	E1.64	1.50
EFiscal '72	E1.90	1.85	1.75

Capitalization Dec. 31

6 3/4% deben. conv. @ $22	$45,732,000
Equity-3,791,584 shares	73,746,542

Fully converted book value: 20.65/share

Net return on book value(annualized):8.33%

1970-71 price range: 18¼-27 3/4
Recent price: 25 3/4

MONY MORTGAGE INVESTORS (MYM-NYSE)
Year ends May

Quar.	---Earnings/share--- Primary	Diluted	Div.
Aug.	$0.21	0.21	$0.19
Nov.	0.24	0.21	0.21
E Fiscal '71	0.92	0.85	0.85

Capitalization Nov. 30

7% deben. conv. @ $11	$48,911,000
Equity (5,037,157 shares)	46,385,309

Fully converted book value:10.06/share

Net return on book (annualized: 8.4%

1970-71 price range: 7¼-13
Recent price: 12 3/8

You should note that the gain in income we have estimated for fiscal 1972 results from the rollover of investments into higher-yielding permanent loans. Equity participations should assume major proportions only in later years. Trustees are considering adopting a posted quarterly dividend rate, adjusting to the year's earnings by a year-end extra. At some point the trust will need additional capital funds but we do not believe this is a near-term possibility. The shares are attractive for sharing in a long-term mortgage portfolio at good yields plus participations in the property's income.

MONY Mortgage Investors is also working the construction loan market while it awaits the time to fund its long-term mortgages. Since beginning operations last April 14, MONY has generated $139.6 million of short-term construction loans and $79.9 million of long-term loans. As of Nov. 30, the trust has funded $72.4 million of the construction loans and $10.6 million of the long-term loans. MONY's construction loans have an apparent annualized yield of 10.1% in the November quarter, a rate consistent with the trust's dealings with larger developers.

MONY's long-term mortgage loans are expected to carry yields comparable to those of ConnGen, with initial investments in the 10.0-10.25% range. The rollover of short-term investments into long-term loans will likely start about the middle of this year and could carry into 1973. About 39% of commitments are for apartment projects, 25% for shopping centers, and 26% for office buildings. They will be located in 19 states.

MONY has attempted to solve the apparent in-house conflict of interest problems inherent in any institutional trust by requiring that the insurance company take a 10% participation interest in every trust permanent loan. The life company acts as adviser to the trust and in the New York headquarters there are no personnel assigned to work exclusively for the trust.

MYM shares have already benefitted from the plunge in interest rates and have moved to new highs recently. At present levels they are valued at about 14 times 1971 estimated fully diluted earnings. The indicated dividend yield of 7.0% is slightly higher than the 6.0% indicated for ConnGen shares. Portfolio holdings appear of good quality and the company has the experience and organization to provide a continuing flow of suitable investments to the trust. Equity participations should provide a moderately growing income stream in coming years and the shares are a good vehicle for longer-term accounts to share in returns from the portfolio.

TRUST SHARES WITH CURRENT ATTRACTION

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We list below trust shares which we believe are attractive for the investment objectives noted at current levels. Recent review dates are noted in parentheses.

<u>Rapid growth and appreciation potential</u>
Guardian Mtg. Inv. (Dec. 28)
First Mtg. Inv. (also warrants)(Nov.25)
Continental Mtg. Inv.
Larwin Mtg. Inv. (Aug.21)
Midland Mtg. Inv.
North American Mtg. Inv. (Sept.24)
Mortgage Inv. Group
Associated Mtg. Inv.
Chase Manhattan Mtg. & Rl(Sept.24)

<u>Longer-term, stable growth-mortgages</u>
C.I. Mtg. Group (Aug. 21)
Barnett Mtg. Trust (Dec.28)Sutro Mtg.
MONY Mtg. Investors
Conn. Gen. Mtg. & Realty
Wachovia Realty Inv.
Medical Mtg. Investors(Feb. 1)
Amer. Fletcher Mtg.
Galbreath Mtg. Inv.

<u>Growth through equity holdings</u>
Real Estate Inv. Trust of America
First Union Real Estate
Pennsylvania Real Estate Trust
General Growth Properties

<u>Above-average current income</u>
American Century Mtg. (Dec. 28)
Alison Mtg. Inv.
Palomar Mtg. Inv.
Riviere Realty Trust

<u>Partially tax-sheltered dividends</u>
First Union Real Estate
Franklin Realty
Washington Real Estate

<u>Recovery to book value</u>
Mobile Home Communities (Feb. 1)